16 Deductions for Taxes

If you itemize deductions on Schedule A, you may deduct your 1996 payments of state, local, and foreign income taxes and real property taxes, as well as state and local personal property taxes. State and local sales taxes are not deductible.

To increase your deduction for state and local taxes, consider making a year-end prepayment of estimated tax liability. You also may be able to increase withholdings from your pay to increase your deduction.

If you pay transfer taxes on the sale of securities or investment real estate, the taxes are not deductible. However, they increase your cost basis when figuring your profit or loss.

Taxes paid in operating a business are generally deductible, except for sales taxes, which are added to the cost of the property.

Taxes claimed as itemized deductions are subject to the 3% reduction of itemized deductions if your adjusted gross income exceeds $117,950, or $58,975 if married filing separately; *see* ¶13.8.

¶16.1 Deductible Taxes

You may deduct as itemized deductions on Schedule A your 1996 payments of:

- State, local, and foreign income taxes.
- State, local, and foreign real property taxes.
- State and local personal property taxes.

In figuring deductible state or local income taxes, include the amount of state or local income tax withheld from your 1996 pay and any estimated tax you paid in 1996 to state or local authorities. Also, do not forget to include tax that you paid in 1996 when you filed your 1995 state and local tax returns.

Taxes incurred in your business are generally deductible on Schedule C; *see* ¶16.11.

If your 1996 adjusted gross income exceeds $117,950, or $58,975 if married filing separately, your deduction for taxes is subject to the 3% reduction computation explained at ¶13.8.

Claim the deduction for deductible taxes on the tax return for the year in which you paid the taxes, unless you report on the accrual basis; *see* ¶16.8.

CHECKLIST OF TAXES

Type of tax—	*Deductible as itemized deduction—*
Admission	No
Alcoholic beverage	No
Assessments for local benefits	No
Automobile license fees not qualifying as personal property tax	No
Cigarette	No
Customs duties	No
Driver's license	No
Estate—federal or state (but *see* ¶11.4)	No
Excise—federal or state, for example, on telephone service	No
Gasoline—federal	No
Gasoline and other motor fuel—state and local	No
Gift taxes—federal and state	No
Income—federal (including alternative minimum tax)	No
Income—state, local, or foreign	Yes
Inheritance tax	No
Mortgage tax	No
Personal property—state or local	Yes
Poll	No
Real estate (state, local, or foreign)	Yes
Regulatory license fees—(dog licenses, parking meter fees, hunting and fishing licenses)	No
Sales and use tax on personal property	No
Social Security	No
Tolls	No
Transfer taxes on securities and real estate	No

¶16.2 Nondeductible Taxes

Sales taxes on personal property are not deductible as itemized deductions. Transfer taxes paid on the sale of securities or investment real estate are not separately deductible, but you may increase your cost basis by the transfer tax in figuring profit or loss on Schedule D.

Gasoline taxes. State and local taxes on gasoline used for personal purposes are not deductible. If you travel for business, the taxes are deductible as part of your gasoline expenses.

¶16.3 Deducting State Income Taxes

You may deduct on your 1996 return state and local income taxes withheld from your pay and estimated state and local taxes paid in 1996. Also deduct the balance of your 1995 state and local taxes you paid during 1996. If you pay in 1997 additional state income tax on your 1996 income, you deduct the payment on your 1997 tax return.

State income taxes may be claimed only as itemized deductions, even if attributed solely to business income. That is, state income taxes may not be deducted as business expenses from gross income.

To increase your itemized deductions on your 1996 return, consider prepaying state income taxes before the end of 1996. The prepayment is deductible provided the state tax authority accepts prepayments and state law recognizes them as tax payments. The IRS has ruled, however, that prepayments are not deductible if you do not reasonably believe that you owe additional state tax. Do not make prepayments if you may be subject to alternative minimum tax; *see* Chapter 23.

If you report on the accrual basis and you contest a tax liability, claim the deduction in the year of payment.

You may deduct on your federal return state and local income taxes allocable to interest income that is exempt from federal tax but not state and local income tax. However, state and local taxes that are allocated to other federal exempt income are not deductible. For example, state income tax allocated to a cost-of-living allowance exempt from federal income tax is not deductible as a state tax.

Mandatory employee contributions to the following state disability or unemployment insurance funds are deductible as state income taxes: California Unemployment Insurance Code; New Jersey Nonoccupational Disability Benefit Fund; New York Nonoccupational Disability Benefit Fund; Rhode Island Temporary Disability Benefit Fund; West Virginia Unemployment Compensation Trust Fund; and the Alabama State Unemployment Fund.

However, employee contributions to a private or voluntary disability plan in California, New Jersey, or New York have been held by the IRS to be nondeductible.

Mandatory employee contributions to a state unemployment fund are deductible.

Note: A refund of state income taxes claimed as an itemized deduction may have to be reported as income; *see* ¶12.7.

¶16.4 When Taxes and Interest Are Capitalized

Uniform capitalization rules (Code Section 263A) may prevent you from deducting taxes and interest incurred on business and investment real estate during a construction or development period; *see* ¶40.2. According to a Tax Court decision, the development period for land started when a development plan was submitted to zoning authorities. The developer was required to capitalize real estate taxes on the raw land, even though no actual development had occurred over a period of several years.

Where property such as nonproductive and undeveloped land is *not* subject to the uniform capitalization rules of Code Section 263A, you may elect to capitalize taxes and interest instead of deducting them. You capitalize the expenses by adding these amounts to the basis of the property. Capitalization may be to your advantage if you do not need the immediate deduction because you have little or no income to offset, or because you do not have itemized deductions or expect a greater tax benefit by adding the taxes to the basis.

EXAMPLE

In 1995 and 1996, Allan White paid taxes and interest on a mortgage on vacant and nonproductive property. In 1996, he operates the property as a parking lot. White may capitalize the taxes and mortgage interest paid in 1995, but not the tax and interest in 1996.

Making the election. Attach to your return a statement of expenses you elect to capitalize; IRS permission is not required. The election must apply to all similar expenses for the same project. An election for unimproved and unproductive real property applies only for the year for which it is made.

¶16.5 Assessments

Assessments by homeowner's association not deductible as taxes. Assessments paid to a local homeowner's association for the purpose of maintaining the common areas of the residential project and for promoting the recreation, health, and safety of the residents are not deductible as real property taxes.

Assessments for government services. If property is used solely as your residence, you may not deduct charges for municipal water bills (even if described as a "tax"), sewer assessments, assessments for sanitation service, or title registration fees. A permit fee to build or improve a personal residence is added to the cost basis of the house.

Assessments for local benefits are deductible if they cover maintenance or repairs of streets, sidewalks, or water or sewer systems, or interest costs on such maintenance. However, assessments for construction of streets, sidewalks, or other local improvements that tend to increase the value of your property are not deductible as real estate taxes. You add such assessments to your cost basis for the property.

If you are billed a single amount, you may deduct the portion allocable to assessments for maintenance or repairs. The burden is on you to support the allocation.

¶16.6 Deducting Real Estate Taxes

You may deduct payments of real estate tax on your property if you claim itemized deductions on Schedule A. The monthly mortgage payment to a bank or other mortgage holder generally includes amounts allocated to real estate taxes, which are paid to the taxing authority on their due date. Mortgage payments allocated to real estate taxes are deductible in the year you make them only if the mortgage holder actually pays them to the tax authority by the end of that year. Typically, banks will furnish you with a year-end statement of disbursements to taxing authorities, indicating dates of payment.

Cooperative apartments. Tenant-stockholders of a cooperative housing corporation may deduct their share of the real estate taxes paid by the corporation. However, no deduction is allowed if the corporation does not own the land and building but merely leases them and pays taxes under the lease agreement. *See also* ¶15.9.

¶16.7 Tenants' Payment of Taxes

You generally may not deduct a portion of your rent as property taxes. This is so even where state or local law identifies a portion of the rent as being tied to tax increases.

Tenants have been allowed a deduction for property taxes in the following areas: In Hawaii, tenants with leases of 15 years or more may deduct the portion of the rent representing taxes. In California, tenants who have their names placed on the tax rolls and who pay the taxes directly to the taxing authority may claim a deduction.

In New York, liability for tax is placed directly on the tenant and the landlord is a collecting agent for paying over the tax to the taxing authorities; the landlord also remains liable for the tax. The IRS ruled that it will not permit tenants to deduct a portion of rent as a payment of taxes.

EXAMPLE

A municipal rent control ordinance allowed landlords to charge real property tax increases to the tenants as a monthly "tax surcharge." The ordinance stated that the surcharge was not to be considered rent for purposes of computing cost-of-living rental increases. The IRS ruled that the tenant may not deduct the "tax surcharge" as a property tax. The tax is imposed on the landlord, not on the tenant. The city ordinance, which permitted the landlord to pass on the tax increases to a tenant, did not shift liability for the property taxes from the landlord to the tenant. For federal tax purposes, the surcharge is merely an additional rental payment by the tenant. Similarly, "rates tax" or "renters' tax" imposed on tenants was ruled to be nondeductible because the tax is imposed on the person using the property rather than the property itself.

¶16.8 Allocating Taxes When You Sell or Buy Realty

When property is sold, the buyer and seller apportion the real estate taxes imposed on the property during the "real property year." A "real property year" is the period which a real estate tax covers. This allocation is provided for you in a settlement statement at the time of closing. If you want to figure your own allocations, your local tax authority can give you the "real property year" of the taxes you plan to apportion. With this information, you then make the following allocation. If *you* are the:

Seller, you deduct that portion of the tax covering the beginning of the real property year through the day before the sale.

Buyer, you deduct the part of the tax covering the date of the sale through the end of the real property year.

EXAMPLE

The real property year in East County starts April 1 and ends March 31. On July 2, 1996, you sell realty located in East County to Jones. Assume the real estate tax for the real property year ending March 31, 1997, is $1,000. You deduct $252 (92/365 of $1,000, since there are 92 days in the period beginning April 1 and ending July 1, 1996). Jones deducts $748 (273/365 of $1,000, since there are 273 days in the period beginning July 2, 1996, and ending March 31, 1997).

Information returns. The IRS requires real estate agents to report in Box 5 of Form 1099-S the buyer's share of real estate taxes on a residence. For example, Smith sells her house in Green County, where the real estate tax is paid annually in advance. In the year of sale she paid $1,200 in real estate taxes. Assuming that the home is sold at the end of the ninth month of the real property tax year, the amount of the real estate tax allocable to the buyer is $300 ($100 per month × 3 months). This amount, which is shown as paid by the seller in advance on an HUD-1 (Uniform Settlement Statement) form provided at the closing, must be reported by the real estate agent as the buyer's share of the real estate tax in Box 5 of Form 1099-S.

The allocation just discussed is mandatory whether or not your contract provides for an allocation. However, you do not allocate taxes of a real property year when:

Property is sold before the real property year. This rule prevents the seller from deducting any part of the tax for that year, even though it became a personal liability or lien while he or she owned the property. The buyer gets the deduction because he or she owns the property for the entire real property year.

Property is sold after the real property year. This rule prevents the buyer from deducting the tax even though it becomes a personal liability or lien after he or she takes possession of the property. The seller gets the deduction because the tax covers the property year in which the seller owns the property. The allocation is limited to a tax covering a property year during which both the seller and the buyer own the property.

When to deduct allocated taxes. After you have made the allocation based on the "real property year," you then must fix the year in which you deduct your share of the allocated tax. Here you consider your method of reporting your income—cash or accrual basis—and the date on which either you or the other party became liable for the tax or paid the tax. If neither you nor the other party is liable for the tax under local law, then the party who holds the property at the time the tax became a lien on the property is considered liable. Check the following rules to determine when you deduct the apportioned tax:

Seller on the cash basis—If the buyer is liable for the tax under local law, the seller may deduct his or her share of the allocated tax either in the year of the sale or a later year when the tax is actually paid. If the seller is liable for the tax under local law, and the tax is not payable until after the sale date, the seller may deduct the tax either in the year of sale or in the year he or she pays the tax.

Buyer on the cash basis—If the seller is liable for the tax under local law, the buyer may deduct the tax either in the year of sale or when the tax is actually paid. If the buyer is liable for the tax, he or she deducts the tax in the year the tax is paid.

Seller on the accrual basis—The seller accrues his or her share of the tax on the date of the sale, unless taxes have been accrued ratably over the years. If this is so, the last accrual is the sale date.

Buyer on the accrual basis—If the seller is liable for the tax, the buyer accrues his or her share of the tax on the date of the sale, unless taxes are accrued ratably. If taxes are accrued ratably, the accrual begins with the date of sale. If the buyer is liable for the tax, he or she deducts the tax in the return for the year the tax accrues unless an election is made to accrue ratably from the date of sale.

Seller's deduction in excess of the allocated amount is taxed. If, in the year before the sale, the seller deducts an amount for taxes in excess of the allocated amount, the excess must be reported as income in the year of the sale. This may happen when the seller is on the cash basis and pays the tax in the year before the sale.

EXAMPLE

A real property tax of $1,000 is due and payable on November 30 for the following calendar year. On November 30, 1995, Keith Jones, who uses the cash basis and reports on a calendar year, pays the 1996 tax. On June 30, 1996, he sells the real property. Under the apportionment rule, Jones is allowed to deduct only $495 (181/366 of $1,000, since there are 181 days in the period from January 1 to June 29, 1996) of the tax for the 1996 real property tax year. But Jones has already deducted the full amount in the 1995 return. Therefore, he reports as income that part of the tax deduction which he was not entitled to under the apportionment.

Buyer may not deduct payment of seller's back taxes. The back taxes paid are added to the cost of the newly purchased property. The amount realized by the seller is increased by the buyer's payment of back taxes.

Seller's payment upon buyer's failure to pay. If a buyer is obligated to pay taxes under a land contract but fails to pay, the owner who pays the tax may deduct the payment if the tax is assessed to him or her.

Buyer of foreclosed property. If you buy realty at a tax sale and you do not receive immediate title to the property under state law until after a redemption period, you may not be able to deduct payment of realty taxes for several years.

¶16.9 Who May Deduct Real Property Taxes

A person who pays a property tax must have an ownership interest in the property to deduct the payment. The following table summarizes who may deduct payments of real property taxes.

If the tax is paid by—	*Then it is deductible by—*
You, for your spouse	Neither, if your spouse has title to the property, and you each file a separate return. This is true even if the mortgage requires you to pay the taxes. The tax is deductible on a joint return.
You, as owner of a condominium	You deduct real estate tax paid on your separate unit. You also deduct your share of the tax paid on the common property.
Your cooperative apartment or corporation	You deduct your share of real estate tax paid on the property; *see* ¶15.9. But if the organization leases the land and building and pays the tax under the terms of the lease, you may not deduct your share.
A life tenant	A court allowed the deduction to a widow required to pay the taxes under a will for the privilege of occupying the house during her life.
A tenant	The tenant of a business lease may deduct the payment of tax as additional rent, not tax. The tenant of a personal residence may not deduct the payment as either a tax or rent expense, unless placed on the real estate assessment rolls, so the tax is assessed directly against him or her; see ¶16.7.
You, as a local benefit tax to maintain, repair, or meet interest costs arising from local benefits	You deduct only that part of the tax which you can show is for maintenance, repair, or interest. If you cannot make the allocation, no deduction is allowed. If the benefit increases the value of the property, you add the nondeductible assessment to the basis of the property.
One whose property was foreclosed for failure to pay taxes	You may not deduct the taxes paid out of the proceeds of the foreclosure sale if your interest in the property ended with the foreclosure.
Tenant by the entirety or joint tenant	The tenant who is jointly and severally liable and who pays the tax. If real property is owned by husband and wife as tenants by the entirety or joint tenants, either spouse may deduct the taxes paid on a separate return or a joint return.
Tenant in common	When property is owned as a tenancy in common, under an IRS rule, a tenant may deduct only his or her share of the tax, even if the entire tax was paid. However, in one case the Tax Court allowed a deduction for the full amount where a co-tenant's payment protected her against the possibility of foreclosure in the event the other co-tenants failed to pay their share of the taxes; *see* ¶9.2.
A mortgagee	No deduction. If tax is paid before the foreclosure, it is added to the loan. If paid after the foreclosure, it is added to the cost of property.

¶16.10 Automobile License Fees

You may not deduct an auto license fee based on weight, model, year, or horsepower. But you may deduct a fee based on the value of the car if these three tests are met: (1) the fee is an *ad valorem* tax, based on a percentage of value of the property; (2) it is imposed on an annual basis, even though it is collected more or less frequently; and (3) it is imposed on personal property. This third test is met even though the tax is imposed on the exercise of a privilege of registering a car or for using a car on the road.

If the tax is based partly on value and partly on weight or other tests, the tax attributed to the value is deductible. For example, assume a registration fee based on 1% of value, plus 40¢ per hundred-weight. The part of the tax equal to 1% of value qualifies as an *ad valorem* tax and is deductible as a personal property tax.

The majority of state motor vehicle registration fees are not *ad valorem* taxes and do not qualify for the deduction. Various states and localities impose *ad valorem* or personal property taxes on motor vehicles that may qualify for the deduction. If you pay fees or taxes on your auto in these states, we suggest you contact a state or local authority to verify the amount of tax qualifying: Arizona, California, Colorado, Connecticut, Georgia, Indiana, Iowa, Maine, Massachusetts, Minnesota, Mississippi, Montana, Nebraska, Nevada, New Hampshire, Oklahoma, Washington, and Wyoming.

¶16.11 Taxes Deductible as Business Expenses

That a tax is not deductible as an itemized deduction does not mean you may not deduct it elsewhere on your return. For example, you may generally deduct property taxes incurred as a cost of doing business on Schedule C. Here are some other examples:

If you pay excise taxes on merchandise you sell in your business, you deduct the tax as a business expense.

If you pay Social Security taxes (FICA) on your employees' wages, you deduct the tax as a business expense on Schedule C.

If you pay sales tax on business property, you add the tax to the cost of the property for depreciation purposes. If the tax is paid on nondepreciable property, the tax is included in the currently deductible cost.

If you pay sales tax on a deductible business meal, the tax is deductible as part of the meal costs, subject to the cost limit discussed at ¶20.26.

50% self-employment tax deduction. One-half of the self-employment tax figured on Schedule SE is deductible from gross income on Line 25 of Form 1040, rather than on Schedule C; *see* ¶46.3.

Note: If you are not a material participant in the business, your Schedule C expenses are subject to passive activity limitations; *see* Chapter 10.

¶16.12 Foreign Taxes

You may deduct your payment of foreign real property taxes and income and excess profits taxes as itemized deductions. Where you pay foreign income or excess profits tax, you have an election of either claiming the tax as a deduction or a credit. Claiming the credit may provide a larger tax savings; *see* ¶36.14.